

## Internal Revenue Service, Treasury

## § 1.704-2

of this section LP and GP are not subject to a minimum gain chargeback.

	LP	GP
Capital account at end of year 3 .....	(\$49,500)	(\$5,500)
Plus: contribution .....	144,000	16,000
Less: net loss in year 4 .....	(62,100)	(6,900)
Capital account at end of year 4 .....	\$32,400	\$3,600
Minimum gain chargeback carryforward .....	\$0	\$0

(v) *Loans of unequal priority.* Assume instead that the building acquired by the partnership is secured by a \$700,000 nonrecourse loan and a \$100,000 recourse loan, subordinate in priority to the nonrecourse loan. Under paragraph (d)(2) of this section, \$700,000 of the adjusted basis of the building at the end of the partnership's third taxable year is allocated to the nonrecourse liability (with the remaining \$30,000 allocated to the recourse liability) so that if the partnership disposed of the building in full satisfaction of the nonrecourse liability at the end of that year, it would realize no gain (\$700,000 amount realized less \$700,000 adjusted tax basis). Therefore, there is no minimum gain (or increase in minimum gain) at the end of the partnership's third taxable year. If, however, the \$700,000 nonrecourse loan were subordinate in priority to the \$100,000 recourse loan, under paragraph (d)(2) of this section, the first \$100,000 of adjusted tax basis in the building would be allocated to the recourse liability, leaving only \$630,000 of the adjusted basis of the building to be allocated to the \$700,000 nonrecourse loan. In that case, the balance of the \$700,000 nonrecourse liability would exceed the adjusted tax basis of the building by \$70,000, so that there would be \$70,000 of minimum gain (and a \$70,000 increase in partnership minimum gain) in the partnership's third taxable year.

(vi) *Nonrecourse borrowing; distribution of proceeds in subsequent year.* The partnership obtains an additional nonrecourse loan of \$200,000 at the end of its fourth taxable year, secured by a second mortgage on the building, and distributes \$180,000 of this cash to its partners at the beginning of its fifth taxable year. In addition, in its fourth and fifth taxable years, the partnership again generates rental income of \$95,000, operating expenses of \$10,000, interest expense of \$80,000 (\$100,000 in the fifth taxable year reflecting

the interest paid on both liabilities), and a depreciation deduction of \$90,000, resulting in a net taxable loss of \$85,000 (\$105,000 in the fifth taxable year reflecting the interest paid on both liabilities). The partnership has distributed its \$5,000 of operating cash flow in each year (\$95,000 of rental income less \$10,000 of operating expense and \$80,000 of interest expense) to LP and GP at the end of each year. If the partnership were to dispose of the building in full satisfaction of both nonrecourse liabilities at the end of its fourth taxable year, the partnership would realize \$360,000 of gain (\$1,000,000 amount realized less \$640,000 adjusted tax basis). Thus, the net increase in partnership minimum gain during the partnership's fourth taxable year is \$290,000 (\$360,000 of minimum gain at the end of the fourth year less \$70,000 of minimum gain at the end of the third year). Because the partnership did not distribute any of the proceeds of the loan it obtained in its fourth year during that year, the potential amount of partnership nonrecourse deductions for that year is \$290,000. Under paragraph (c) of this section, if the partnership had distributed the proceeds of that loan to its partners at the end of its fourth year, the partnership's nonrecourse deductions for that year would have been reduced by the amount of that distribution because the proceeds of that loan are allocable to an increase in partnership minimum gain under paragraph (h)(1) of this section. Because the nonrecourse deductions of \$290,000 for the partnership's fourth taxable year exceed its total deductions for that year, all \$180,000 of the partnership's deductions for that year are treated as nonrecourse deductions, and the \$110,000 excess nonrecourse deductions are treated as an increase in partnership minimum gain in the partnership's fifth taxable year under paragraph (c) of this section.

	LP	GP
Capital account at end of year 3 (including cash flow distributions) .....	(\$63,000)	(\$7,000)
Plus: rental income in year 4 .....	85,500	9,500
Less: nonrecourse deductions in year 4 .....	(162,000)	(18,000)
Less: cash flow distributions in year 4 .....	(4,500)	(500)
Capital account at end of year 4 .....	(\$144,000)	(\$16,000)

At the end of the partnership's fourth taxable year, LP's and GP's shares of partnership minimum gain are \$225,000 and \$25,000, respectively (because the \$110,000 excess of nonrecourse deductions is carried forward to the next year). If the partnership were to dispose of the building in full satisfaction of the nonrecourse liabilities at the end of its fifth taxable year, the partnership would realize \$450,000 of gain (\$1,000,000 amount realized less \$550,000 adjusted tax basis). Therefore, the net increase in partnership minimum gain during the partnership's fifth taxable year is \$200,000 (\$110,000 deemed increase plus the \$90,000 by which minimum gain at the end of the fifth year exceeds minimum gain at the end of the fourth year (\$450,000 less \$360,000)). At the beginning of its fifth year, the partnership distributes \$180,000 of the loan proceeds (retaining \$20,000 to pay the additional interest expense). Under paragraph (h) of this section, the first \$110,000 of this distribution (an amount equal to the deemed increase in partnership minimum gain for the year) is considered allocable to an increase in partnership minimum gain for the year. As a result, the amount of nonrecourse deductions for the partnership's fifth taxable year is \$90,000 (\$200,000 net increase in minimum gain less \$110,000 distribution of nonrecourse liability proceeds allocable to an increase in partnership minimum gain), and the nonrecourse deductions consist solely of the \$90,000 depreciation deduction allowable with respect to the building. As a result of the distributions during the partnership's fifth taxable year, the total distributions to the partners over the partnership's life equal \$205,000. Therefore, the last \$5,000 distributed to the partners during the fifth year will be divided equally between them under the partnership agreement. Thus, out of the \$185,000 total distribution during the partnership's fifth taxable year, the first \$180,000 is distributed 90 percent to LP and 10 percent to GP, and the last \$5,000 is divided equally between them.

	LP	GP
Capital account at end of year 4	(\$144,000)	(\$16,000)
Less: net loss in year 5 (without nonrecourse deductions) .....	(13,500)	(1,500)
Less: nonrecourse deductions in year 5 .....	(81,000)	(9,000)
Less: distribution of loan proceeds .....	(162,000)	(18,000)
Less: cash flow distribution in year 5 .....	(2,500)	(2,500)
Capital account at end of year 5	(\$403,000)	(\$47,000)

At the end of the partnership's fifth taxable year, LP's share of partnership minimum gain is \$405,000 (\$225,000 share of minimum gain at the end of the fourth year plus \$81,000 of nonrecourse deductions for the fifth year and a \$99,000 distribution of nonrecourse liability proceeds that are allocable to an increase in minimum gain) and GP's share of partnership minimum gain is \$45,000 (\$25,000 share of minimum gain at the end of the fourth year plus \$9,000 of nonrecourse deductions for the fifth year and an \$11,000 distribution of nonrecourse liability proceeds that are allocable to an increase in minimum gain).

(vii) *Partner guarantee of nonrecourse debt.* LP and GP personally guarantee the "first" \$100,000 of the \$800,000 nonrecourse loan (*i.e.*, only if the building is worth less than \$100,000 will they be called upon to make up any deficiency). Under paragraph (d)(2) of this section, only \$630,000 of the adjusted tax basis of the building is allocated to the \$700,000 nonrecourse portion of the loan because the collateral will be applied first to satisfy the \$100,000 guaranteed portion, making it superior in priority to the remainder of the loan. On the other hand, if LP and GP were to guarantee the "last" \$100,000 (*i.e.*, if the building is worth less than \$800,000, they will be called upon to make up the deficiency up to \$100,000), \$700,000 of the adjusted tax basis of the building would be allocated to the \$700,000 nonrecourse portion of the loan because the guaranteed portion would be inferior in priority to it.

(viii) *Partner nonrecourse debt.* Assume instead that the \$800,000 loan is made by LP, the limited partner. Under paragraph (b)(4) of this section, the \$800,000 obligation does not constitute a nonrecourse liability of the partnership for purposes of this section because LP, a partner, bears the economic risk of loss for that loan within the meaning of § 1.752-2. Instead, the \$800,000 loan constitutes a partner nonrecourse debt under paragraph (b)(4) of this section. In the partnership's third taxable year, partnership minimum gain would have increased by \$70,000 if the debt were a nonrecourse liability of the partnership. Thus, under paragraph (i)(3) of this section, there is a net increase of \$70,000 in the minimum gain attributable to the \$800,000 partner nonrecourse debt for the partnership's third taxable year, and \$70,000 of the \$90,000 depreciation deduction from the building for the partnership's third taxable year constitutes a partner nonrecourse deduction with respect to the debt. See paragraph (i)(4) of this section. Under paragraph (i)(2) of this section, this partner nonrecourse deduction must be allocated to LP, the partner that bears the economic risk of loss for that liability.

(ix) *Nonrecourse debt and partner nonrecourse debt of differing priorities.* As in Example 1 (vii) of this paragraph (m), the \$800,000

loan is made to the partnership by LP, the limited partner, but the loan is a purchase money loan that “wraps around” a \$700,000 underlying nonrecourse note (also secured by the building) issued by LP to an unrelated person in connection with LP’s acquisition of the building. Under these circumstances, LP bears the economic risk of loss with respect to only \$100,000 of the liability within the meaning of § 1.752-2. See § 1.752-2(f) (*Example 6*). Therefore, for purposes of paragraph (d) of this section, the \$800,000 liability is treated as a \$700,000 nonrecourse liability of the partnership and a \$100,000 partner nonrecourse debt (inferior in priority to the \$700,000 liability) of the partnership for which LP bears the economic risk of loss. Under paragraph (i)(2) of this section, \$70,000 of the \$90,000 depreciation deduction realized in the partnership’s third taxable year constitutes a partner nonrecourse deduction that must be allocated to LP.

*Example 2. Netting of increases and decreases in partnership minimum gain.* For *Example 2* unless otherwise provided, the following facts are assumed. X and Y form a general partnership to acquire and operate residential real properties. Each partner contributes \$150,000 to the partnership. The partnership obtains a \$1,500,000 nonrecourse loan and purchases 3 apartment buildings (on leased land) for \$720,000 (“Property A”), \$540,000 (“Property B”), and \$540,000 (“Property C”). The nonrecourse loan is secured only by the 3 buildings, and no principal payments are due for 5 years. In each of the partnership’s first 3 taxable years, it generates rental income of \$225,000, operating expenses (including land lease payments) of \$50,000, interest expense of \$175,000, and depreciation deductions on the 3 properties of \$150,000 (\$60,000 on Property A and \$45,000 on each of Property B and Property C), resulting in a net taxable loss of \$150,000 in each of those years. The partnership makes no distributions to X or Y.

(i) *Calculation of net increases and decreases in partnership minimum gain.* If the partnership were to dispose of the 3 apartment buildings in full satisfaction of its nonrecourse liability at the end of its third taxable year, it would realize \$150,000 of gain (\$1,500,000 amount realized less \$1,350,000 adjusted tax basis). Because the amount of partnership minimum gain at the end of that year (and the net increase in partnership minimum gain during that year) is \$150,000, the amount of partnership nonrecourse deductions for that year is \$150,000, consisting of depreciation deductions allowable with respect to the 3 apartment buildings of \$150,000. The result would be the same if the partnership obtained 3 separate nonrecourse loans that were “cross-collateralized” (*i.e.*, if each separate loan were secured by all 3 of the apartment buildings).

(ii) *Netting of increases and decreases in partnership minimum gain when there is a disposi-*

*tion.* At the beginning of the partnership’s fourth taxable year, the partnership (with the permission of the nonrecourse lender) disposes of Property A for \$835,000 and uses a portion of the proceeds to repay \$600,000 of the nonrecourse liability (the principal amount attributable to Property A), reducing the balance to \$900,000. As a result of the disposition, the partnership realizes gain of \$295,000 (\$835,000 amount realized less \$540,000 adjusted tax basis). If the disposition is viewed in isolation, the partnership has generated minimum gain of \$60,000 on the sale of Property A (\$600,000 of debt reduction less \$540,000 adjusted tax basis). However, during the partnership’s fourth taxable year it also generates rental income of \$135,000, operating expenses of \$30,000, interest expense of \$105,000, and depreciation deductions of \$90,000 (\$45,000 on each remaining building). If the partnership were to dispose of the remaining two buildings in full satisfaction of its nonrecourse liability at the end of the partnership’s fourth taxable year, it would realize gain of \$180,000 (\$900,000 amount realized less \$720,000 aggregate adjusted tax basis), which is the amount of partnership minimum gain at the end of the year. Because the partnership minimum gain increased from \$150,000 to \$180,000 during the partnership’s fourth taxable year, the amount of partnership nonrecourse deductions for that year is \$30,000, consisting of a ratable portion of depreciation deductions allowable with respect to the two remaining apartment buildings. No minimum gain chargeback is required for the taxable year, even though the partnership disposed of one of the properties subject to the nonrecourse liability during the year, because there is no net decrease in partnership minimum gain for the year. See paragraph (f)(1) of this section.

*Example 3. Nonrecourse deductions and partnership minimum gain before third partner is admitted.* For purposes of *Example 3*, unless otherwise provided, the following facts are assumed. Additional facts are given in each of *Examples 3* (ii), (iii), and (iv). A and B form a limited partnership to acquire and lease machinery that is 5-year recovery property. A, the limited partner, and B, the general partner, contribute \$100,000 each to the partnership, which obtains an \$800,000 nonrecourse loan and purchases the machinery for \$1,000,000. The nonrecourse loan is secured only by the machinery. The principal amount of the loan is to be repaid \$50,000 per year during each of the partnership’s first 5 taxable years, with the remaining \$550,000 of unpaid principal due on the first day of the partnership’s sixth taxable year. The partnership agreement contains all of the provisions required by paragraph (e) of this section, and, as of the end of each partnership taxable year discussed herein, the items described in § 1.704-1(b)(2)(ii)(d) (4), (5), and (6)